Accounting Methods Spotlight / Issue 4 / April 2013

Recent IRS rulings provide guidance on a range of tax accounting issues

In this month's Accounting Methods Spotlight, taxpayers are given timely insight into the benefical extension of the 'enhanced' deduction for charitable contributions of food inventory. This month's issue also provides updates on a range of federal income tax matters, including whether minimum royalties must be capitalized under Section 263A, whether certain payments under settlement agreements are deductible as business expenses, and whether the transfer of a patent pursuant to a licensing agreement can later be recharacterized as a sale. In addition, this issue discusses the deferral of tax from a like-kind exchange (LKE) program and whether a bank is required under Section 263A to capitalize costs associated with "other Real Estate Owned."

Did you know..?

Beneficial extension of 'enhanced' deduction for charitable contributions of food inventory

The American Taxpayer Relief Act of 2012 (ATRA) retroactively extended the Section 170(e)(3)(C) 'enhanced' deduction for qualifying charitable contributions of food inventory made by taxpayers that are not C corporations (e.g., partnerships, S corporations). This deduction had expired at the end of calendar year 2011, but the ATRA retroactively extended it through calendar year 2013, providing another opportunity for

taxpayers that are not C corporations to obtain a greater benefit for their charitable contributions.

While many taxpayers will be able to take advantage of this opportunity, some taxpayers may discover that they are unable to efficiently capture the information necessary to document and support the enhanced deduction. This is most likely to occur where a taxpayer's management is highly decentralized, where a taxpayer operates a vertically-integrated group of businesses that has significant intercompany transfers of inventory, or where a taxpayer's Enterprise Resource Planning (ERP) system is inadequate.

If a taxpayer cannot efficiently capture the information necessary to document and support the enhanced deduction, the taxpayer should consider employing statistical sampling, an IRS pre-filing agreement, or both in order to streamline the process. Successful integration of these types of programs can help taxpayers more efficiently capture the information necessary to claim the additional tax benefit associated with charitable contributions of food inventory.

Other guidance

Minimum royalties must be capitalized under Section 263A

The IRS concluded in recently released field attorney advice (FAA 20124401F) that minimum royalties paid for the use of licensed patents must be capitalized to ending inventory under Section 263A. The conclusions reached in the FAA could impact any taxpayer with a minimum royalty arrangement.

In the FAA, the taxpayer develops, manufactures, markets, and sells a product. The taxpayer requires the use of certain patented technology in order to manufacture the product. The taxpayer entered into a licensing agreement that provides for several types of compensation, including two types of royalties -- the earned royalty and the minimum royalty. The earned royalty is computed using a specified dollar amount for each unit sold or leased; the minimum royalty is a fixed annual amount against which any earned royalty for the same year is credited.

During the years in question, the earned royalties exceeded the minimum royalty. The taxpayer argued that, based on this fact, the minimum royalty was never triggered, and only earned royalties were paid. As a result, the taxpayer deducted all the royalty payments as cost of goods sold. The IRS disagreed and asserted that the minimum royalty paid for the use of the licensed patents must be capitalized to ending inventory under Section 263A.

In the FAA, the IRS did not dispute that the earned royalties in excess of the minimum royalty should be allowed as cost of goods sold. The earned royalties were calculated based on the number of units sold and became due only upon sale, so the IRS agreed that the earned royalties should be considered sales-based royalties within the meaning of the proposed regulations. Similarly, the taxpayer did not dispute the clear authority under both the current and proposed regulations that minimum royalties must be capitalized.

The disagreement between the IRS and the taxpayer pertained to characterization of the royalties paid. The taxpayer argued that the minimum royalty was never paid because the earned royalties exceeded the minimum royalty and, thus, only earned royalties were paid. The IRS argued that both minimum and earned royalties were paid. The license agreement provided that the minimum royalty was incurred and payable for each year (or partial year) in which the license agreement was in effect, regardless of sales. Although the earned royalties were credited against the minimum royalty, the taxpayer's liability for the minimum royalty was unaffected by the amount of earned royalties or the number of units sold. Based on the law and its analysis, the IRS concluded that the minimum royalty paid for the use of licensed patents must be capitalized to ending inventory under Section 263A.

Payments under settlement agreement are deductible business expenses

In CCA 201308027, the IRS concluded that a payment under a settlement agreement with a state's attorney general does not constitute a fine or similar penalty under Section 162(f) and is therefore an ordinary and necessary business expense deductible under Section 162(a).

According to an investigation by the state's attorney general, the taxpayer engaged in certain deceptive and illegal practices that violated certain state statutes. Upon these findings, the taxpayer entered into an agreement to settle with the attorney general instead of enduring civil action. As required under the terms of the agreement, the taxpayer paid an amount to one of the state's non-profit organizations and paid the state to cover the incurred investigation costs.

Section 162(f) states that a deduction is prohibited for any fine or similar penalty paid to a government for the violation of any law. In its analysis, the IRS relied upon Treas. Reg. Section 1.162-21(b)(2), which states that compensatory damages paid to a government do not fall within the definition of a 'fine or similar penalty.' The IRS then determined whether the nature of the taxpayer's settlement payment was punitive or compensatory by considering the language of the state statutes that were violated. The statutes specifically allow the attorney general to 'seek restitution and damages' in violation, which the IRS explains has the clear purpose of providing compensation to victims rather than punishment for the perpetrators. As a result, the IRS concludes that restitution in the context of the settlement payment is compensatory in nature and does not meet the definition of a fine or penalty.

The IRS states that under Section 162(a), an amount paid by a taxpayer's business to avoid or settle litigation may be deductible as an ordinary and necessary business expense. Therefore, since the settlement payment does not constitute a fine or similar penalty under Section 162(f), the payment is deductible as a business expense.

Prepaid FDIC assessment must be capitalized

In CCA 201311021, the IRS concluded that a prepaid FDIC assessment does not satisfy the 12-month rule, and as such, is not currently deductible under Treas. Reg. Section 1.263(a)-4(f)(1).

The taxpayer is the parent of various banking subsidiaries whose deposits are insured by the FDIC. The FDIC's deposit insurance fund is replenished with risk-based assessment payments made by insured banks, including the taxpayer's banks. In 2009, the FDIC started a program which required insured banks to pay a prepaid assessment in order to restore the FDIC's deposit insurance funds and increase liquidity. The prepaid assessment made by each bank was equal to the bank's estimated quarterly risk-based assessment aggregated for the subsequent 13 quarters (3.25 years) and was required to be paid by December 2009. Over the three-year period, the FDIC had the ability and discretion to return any unused portion of the prepaid assessment to an insured bank. The taxpayer's banks timely paid the prepaid assessment and claimed a deduction through a Schedule M adjustment on each of its following three tax returns for the subsequent year's portion of the prepaid assessment, relying on the 12-month rule of Treas. Reg. Section 1.263(a)-4(f)(1).

In this CCA, the IRS first argued that the prepaid assessment must be capitalized because the useful life extends substantially beyond the close of the taxable year. The IRS also asserted that the assessment is an 'amount paid to create a separate and distinct intangible asset' under Treas. Reg. Section 1.263(a)-4(b)(1)(iii) because amounts in the fund are revertible to the taxpayer and as such were required to be capitalized.

More importantly, the IRS contended that the prepaid assessment does not meet the 12-month rule, as argued by the taxpayer, because under a plain reading of Treas. Reg. Section 1.263(a)-4(f)(1), the taxpayer's right or benefit must not 'extend beyond the earlier of (i) 12 months [...] or (ii) the end of the taxable year following the taxable

year in which the payment is made.' The IRS argued that the right or benefit from the prepaid assessment started in December 2009 and extended well beyond 12 months or the end of the following tax year, as the useful life of the prepaid assessment was 3.25 years. The IRS also dismissed the argument that the taxpayer's prepaid assessment could be treated as 13 separate and distinct prepayments for each quarterly assessment because the FDIC regulations requiring the prepaid assessment clearly state that the prepayment is a single, unitary amount that can be drawn upon to satisfy any quarter's assessment. Therefore, the IRS concluded that the banks' prepaid FDIC assessment does not meet the 12-month rule and was therefore required to be capitalized and taken into account over its useful life.

Patent transfer held to be a license, not a sale

In FAA 20123001F, the IRS concluded that a taxpayer that treated the transfer of a patent as a licensing agreement cannot later recharacterize the transfer as a sale, and that the taxpayer must be held to the substance and the form of the agreements. As such, a lump sum payment made to the taxpayer was determined to be licensing income, treated as ordinary income.

The taxpayer transferred a patent in exchange for annual payments of sales-based royalties. The taxpayer later renegotiated the agreements in order to receive a lump sum payment in lieu of annual royalties. To reduce its taxes resulting from the lump sum payment, the taxpayer triggered a large capital loss in a subsequent year and carried the loss back to the year of the lump sum payment. The taxpayer maintained that its license agreements were sales and that the income from these transactions was capital in character. However, in a closing agreement for a different year, the taxpayer represented that the agreement was a license and reported the royalties as ordinary income.

In analyzing the taxpayer's facts, the IRS considered the rule in *Waterman v. Mackenzie*, 138 U.S. 252 (1891) to determine whether the transfer was a license. Under *Waterman*, a transferor must transfer all the rights to make, use and sell the patent; anything less is a license. The IRS rejected the taxpayer's claim that tax law no longer follows patent law.

After considering the facts, the IRS determined that the payments made to the taxpayer were ordinary income, and not capital gains as the taxpayer claimed. The IRS noted that if the transfer was treated as a sale, it would contradict the taxpayer's prior closing agreement, as well as the taxpayer's SEC filings and income tax returns. The IRS also noted that a closing agreement can decide matters in subsequent tax years, even if the years are not mentioned. Further, the IRS concluded that the transfer agreement was in form a license, and that the taxpayer, having chosen as much, must be held to the form of its agreement.

Like-kind exchange program does not qualify for deferral of tax

The IRS concluded in FAA 20124801F that a taxpayer had actual or constructive receipt of proceeds from the sale of relinquished property in an intended like-kind exchange (LKE) program, and thus could not defer the tax from the LKE program under Section 1031.

The taxpayer is an LLC that purchases cars and leases them to a car rental company. The taxpayer entered into an exchange agreement with a qualified intermediary (QI) to facilitate a LKE program. As part of the LKE program, the taxpayer sold its vehicles (i.e., relinquished property) to automobile manufacturers and dealers through wholesale auctions and brokers.

The vehicle sale proceeds moved through three accounts: (1) QI collection account, (2) qualified escrow account, and (3) repayment account. The QI collection account was a restricted account maintained by the QI, to which the taxpayer had assigned its rights and in which the sales proceeds were deposited. The proceeds were then transferred to a qualified escrow account by an automatic nightly sweep. Lastly, the taxpayer sent a transfer request to the bank, which transferred the sales proceeds

from the qualified escrow account into the repayment account. The taxpayer sometimes used the funds in the repayment account to purchase vehicles outside of the LKE program.

The IRS argued that the taxpayer did not meet the requirements of Treas. Reg. Section 1.1031(k)-1, which allows deferred exchanges to receive like-kind treatment, because the exchange was actually the sale of property followed by the purchase of like-kind property. If a taxpayer actually or constructively receives money or property *before* the like-kind replacement property is received, then the transaction becomes a sale and gain or loss must be recognized. Under Treas. Reg. Section 1.1031(k)-1(f)(2), a taxpayer is in construction receipt at the time the money or property is 'set apart for the taxpayer or otherwise made available so that the taxpayer may draw upon it at any time.' Therefore, when the sales proceeds entered account (3), the repayment account, the IRS argued that the taxpayer constructively received the money as a result of its ability to use the funds, as evidenced by the taxpayer's actual use to purchase vehicles outside of the LKE program. The IRS concluded that this sale, followed by a purchase of like-kind property, was not a deferred exchange and did not qualify for deferral of tax under Section 1031.

Exterior HVAC units are not qualified leasehold improvement property

In CCA 201310028, the IRS concluded that exterior HVAC units are not qualified leasehold improvement property (QLIP) under Section 168(e)(6) because they are not improvements to an interior portion of a building.

The taxpayer is engaged in a lease agreement that delegates the responsibility of improving the leased space (a large, stand-alone commercial building) to the lessee (i.e., the taxpayer). The taxpayer replaced several HVAC units, located both on the roof of the building and on concrete pads adjacent to the building. The HVAC units otherwise satisfy the requirements of QLIP under Section 168(k)(3) (i.e., the improvement is made pursuant to a lease, occupied exclusively by the lessee, placed in service three years after the building was placed in service).

According to Section 168(k)(3)(A), the definition of QLIP begins with 'any improvement to an *interior* portion of a building.' The central issue analyzed by the IRS was whether the HVAC units on the outside of the building can constitute an 'interior portion of the building' under any guidance. The IRS stated that there is no guidance in the statute, legislative history, or regulations on the meaning of 'interior portion' of a building. Therefore, the IRS turned to the dictionary definition of 'interior,' which means 'being within the limiting surface or boundary,' or inside the building, in considering what this term means for purposes of Section 168(k)(3)(A). Based on this definition, the IRS concluded that the HVAC units were not improvements to the interior portion of the building and thus did not qualify as QLIP under Section 168(e)(6). Therefore, the HVAC units must be recovered over 39 years as required for nonresidential real property instead of the 15-year period allowed for QLIP.

IRS addresses application of Section 263A to OREO property

The Service recently issued informal guidance that addresses whether a bank is required under Section 263A to capitalize costs (e.g., property taxes) associated with 'other Real Estate Owned' by the bank (OREO). When a borrower defaults on a mortgage loan, a bank may acquire the title to, and possession of, OREO property through either a foreclosure proceeding or voluntarily from the debtor through a deed-in-lieu of foreclosure transaction. Under Section 263A, a taxpayer is generally required to capitalize the direct costs and certain indirect costs property allocable to property produced or acquired for resale.

Initially, in field attorney advice (FAA 20123201F), IRS field counsel determined that the direct costs and an allocable share of indirect costs associated with OREO property that was either improved by a bank or primarily held for sale by the bank

must be capitalized to the basis of the property under Section 263A. In contrast, the FAA also concludes that the normal operating expenses (e.g., property taxes) associated with OREO property held by the bank as rental property, as opposed to being held for production or for resale, would not be subject to capitalization under Section 263A.

In reaching this determination, the FAA concludes that the bank was often a reseller of the OREO property because the OREO property acquired by the bank in foreclosure is often acquired with the intent to resell the property. In particular, the FAA noted that this intent was evidenced by bank regulations that restrict the holding period for OREO property by the bank, which expected the bank to exercise good faith efforts to sell the property. The FAA also notes that its conclusion was based on case law and published guidance that held that OREO property acquired through foreclosure was held 'primarily for sale in the ordinary course of [a] bank's trade or business' within the meaning of Section 1221(a)(1).

Subsequently, in general legal advice memorandum (GLAM 2013-001), the IRS National Office appears, at first glance, to disagree with the FAA. In contrast to the FAA, the GLAM holds that "where the loan-originating Bank acquires real property through foreclosure or deed-in-lieu of foreclosure and promptly attempts to sell the OREO without improvement, ...the property is not 'property acquired for resale' within the meaning of §263A". The GLAM reaches this conclusion even though it is assumed, as a factual matter, that the bank properly accounts for its OREO property as property described in Section 1221(a)(1).

In reaching its conclusion, the GLAM considered Treas. Reg. Section 1.263A-1(b)(13) which provides that the origination of loans is not considered the acquisition of property for resale, notwithstanding the frequency with which the taxpayer sells the loans it originates or the percentage of its originated loans that is sells. The GLAM then concludes that a bank's acquisition of OREO property through either a foreclosure proceeding or a deed-in-lieu of foreclosure transaction does not convert the bank into a reseller if the foreclosure proceeding or deed-in-lieu of foreclosure transaction are viewed as an extension of the bank's loan origination activity. Instead, the GLAM argues that the bank in these situations is acting as a lender and not as a reseller of property, as the bank only takes title and possession of the property as a last resort to recover funds. As a result, the GLAM holds that the property is not property acquired for resale within the meaning of Section 263A(b)(2)(A). Importantly, however, it must be noted that the GLAM does not address whether the costs incurred by a bank to make improvements to OREO properties would be subject to capitalization under Sections 263(a) and 263A. Whether a particular amount is deductible as a repair or capitalizable as an improvement must be separately determined under Treas. Reg. Section 1.263(a)-3T.

Judicial doctrines should not prevent deferred gain recognition

In FAA 20123401F, the IRS explained that the substance over form and step transaction doctrines should not be applied to prevent a taxpayer from deferring gain recognition.

The taxpayer, in relevant years, held assets in various locations. The taxpayer needed to generate a large amount of cash, and as a result, the taxpayer's Board of Directors approved a plan that required the taxpayer to sell a portion of its assets.

As part of the plan to raise cash, the taxpayer engaged in an 'orchestrated series' of transactions between several parties pursuant to a promoted transaction. The transaction involved a four stage bid selection process through which interested parties were invited to bid on the assets being sold. The sale was accomplished through the use of installment notes and standby letters of credit, which was outlined as part of the bid package provided by the taxpayer's advisors. As a whole, the transaction allowed the taxpayer to defer reporting sale proceeds and recognizing gain from an asset sale as provided under Section 453. The transaction also allowed the taxpayer to obtain cash approximately equal to the sales proceeds from a loan

secured by the installment sale notes. Because the property at issue was farm property, the taxpayer could pledge the notes without the proceeds being treated as payment under the installment sale rules.

One of the issues raised as a result of the taxpayer's transaction was whether the IRS should assert the 'substance over form doctrine' to disregard the form of the taxpayer's transaction and disallow the taxpayer's deferral of gain recognition on its sale of the asset. Alternatively, the IRS considered whether it should assert the 'step transaction doctrine' to disregard certain steps of the taxpayer's transaction and disallow the taxpayer's deferral of gain recognition on its sale of the asset.

After considering the facts, the IRS concluded that under the *Newman v. Commissioner* criteria, the substance of the transaction was consistent with its form. The IRS found that each step in the transaction had a specific business purpose. The asset sale was determined to be a real transaction carried out to raise cash for the taxpayer. The letters of credit provided economic security for the taxpayer in the event of the buyer's default, and the deposits served as the collateral. Further, the IRS found that the economic interests of the parties had changed after the transaction because the taxpayer no longer owned the assets that it sold. Moreover, the IRS found no indication that the terms of the transaction were not at arm's length. According to the IRS, the terms of the purchase notes were regular, commercial terms, with market-based interest rates. Although the interest rate on the loans was determined to be unusual, the loan agreement showed that it was structured as a commercial loan. Finally, the IRS found that all parties involved in the transaction treated the steps as a separate installment sale and monetization loan.

As a result, the IRS advised that the substance-over-form doctrine should not be applied to prevent the taxpayer from deferring gain recognition. As to the application of the step transaction doctrine, the IRS concluded that because the step transaction doctrine is an extension of the substance over form doctrine, the step transaction doctrine, likewise, did not apply.

Taxpayer not entitled to abandonment loss deduction

In FAA 20124603F, the IRS concluded that the taxpayer was not entitled to a deduction for an abandonment loss of a community project because it did not abandon the project and continued to pursue its claim for recovery.

The taxpayer approved a development project to construct active adult homes in a golf course community. Due to market downturn, the project was later renegotiated and restructured. The taxpayer entered into two agreements with the seller to buy finished lots. The taxpayer then entered into a third contract with the seller, under which the taxpayer would construct an amenity center and the seller would reimburse the costs. The taxpayer had to make a deposit to be applied to the purchase of the developed lots as the seller completed the development. After delivery of the developed lots by the seller, a deposit was still left to be made. The taxpayer ultimately sued the seller for failure to fulfill its contractual obligations. Subsequently, the taxpayer and the seller entered into another agreement providing for the purchase of acreage, including entitlements to several homes. The agreement also gave the taxpayer title to the amenity site. The question before the IRS was whether the taxpayer was entitled to an abandonment loss on the remaining deposit amount.

To properly claim an abandonment loss deduction under Section 165, a taxpayer must be able to ascertain with reasonable certainty whether it will receive reimbursement for the loss. The regulations provide that the loss must be evidenced by a closed and completed transaction, fixed by an identifiable event. The 'identifiable event' must be observable to outsiders and constitute some step which irrevocably cuts ties to the asset.

The taxpayer argued that it informed the seller of its intent to 'walk away' from the project. Additionally, the IRS noted that the taxpayer could also argue that it acted to

abandon the community project halfway through Year 4, when it terminated its selling efforts of the development and ceased construction of the amenity center. However, the IRS pointed to several acts and events that show the taxpayer did not irrevocably cut ties with the project and did not intend to abandon the project. On the contrary, the facts and circumstances, including the taxpayer's ongoing litigation, settlement negotiations, and a purchase agreement, provided evidence that the taxpayer had not sustained an abandonment loss in that year.

As a result, the IRS ruled against the taxpayer and concluded that the taxpayer was not entitled to a deduction for an abandonment loss under Section 165.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

James Connor, *Washington, DC*
+1 (202) 414-1771
james.e.connor@us.pwc.com

Adam Handler, *Los Angeles*
+1 (213) 356-6499
adam.handler@us.pwc.com

Jenifer Kennedy, *Washington, DC*
+1 (202) 414-1543
jennifer.kennedy@us.pwc.com

George Manousos, *Washington, DC*
+1 (202) 414-4317
george.manousos@us.pwc.com

Annette Smith, *Washington, DC*
+1 (202) 414-1048
annette.smith@us.pwc.com

Dennis Tingey, *Phoenix*
+1 (602) 364-8107
dennis.tingey@us.pwc.com

Christine Turgeon, *New York*
+1 (646) 471-1660
christine.turgeon@us.pwc.com

James Martin, *Washington, DC*
+1 (202) 414-1511
james.e.martin@us.pwc.com